The Collapse of Enron: How Arrogance and Greed Helped To Destroy One of America's Largest Corporations

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Introduction

Few stories have dominated the business headlines in the US in recent history as the failure of energy trading company Enron. Once the darling of Wall Street with such a high market cap (US$ 60 billion) that placed it number seven on the Fortune 500 list of largest U.S. companies, Enron has for all practical purposes fallen into bankruptcy. The fallout from Enron's failure is far-reaching. Banks and utilities have lost hundreds of millions of dollars in various investments. Enron's accounting firm Anderson, once a major corporate top-five accounting company, is now looking at its own destruction after improper financial dealings with Enron. Enron's demise has sent shock waves throughout the business world: from investors who got wiped out from the devastation incurred in their retirement accounts; to practically every major corporation throughout the U.S. scurrying around to ensure the legitimacy of their own financial practices; to the accounting firms which service these corporations who worry about their own solvency.

Such abrupt falls from lofty heights recur in U.S. financial markets. Junk bond giant Drexel Burnham Lambert crashed in the 1980's. In the 1990's it was Long Term Capital Management, a colossus hedge fund. Like Enron, Drexel and Long Term Capital helped establish and dominate new markets designed to help companies and investors better control their financial risks. And, just like Enron, both were wiped out by failing to see the risks that they had taken on themselves.

Personally, I am very familiar with the Enron story, as it was a core holding in my mother's portfolio. As I am considered to be the most knowledgeable about the markets in my family, I would have to spend considerable time looking at stocks for various family members and try to provide some useful guidance. As for Enron, I can recall not being able to find any negative information about the company in the late 1990's-it seemed everyone on Wall Street loved this company. Therefore, I told my mother at the time I thought she was right in owning Enron stock. Fortunately, my mother eventually sold her Enron shares before the collapse, but the experience proved to be a valuable lesson on just how easy it is to overlook vital clues in determining a company's financial health.

The internal problems that plagued Enron existed for some time, but were easily overlooked by the culture surrounding the organization. A soaring stock market and vibrant economy gave little incentive to detailed scrutinizing of the company's internal conditions. Several warning signs of its impending fate could be found in Enron's formative. Crucial factors that were overlooked include:

A Lack of Clarity

One of the biggest lessons learned from the Enron fiasco is that accounting really matters. According to numerous Wall Street firms who have analyzed Enron's accounting procedures, since early from its inception Enron never fully

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disclosed its assets and liabilities in a manner that could be readily and easily interpreted. It was continually performing all sorts of maneuvers to take as many of its assets as it could off of its books. In many cases those assets were tied up with partnerships controlled by Enron executives. When the partnerships soured, Enron's business inevitably suffered. Precisely what kind of assets remains unclear; what is known, however, is that the executives of Enron who were involved in the partnerships made millions of dollars in management fees by brokering and administering the deals. Because these partnerships were so complex and intertwined with each other, Enron's financial statements were vague at best, and totally incomprehensible at worst. Although the executives at Enron probably did lie about their financial condition, with their extremely complex financial reports they didn't have to. Their complexity was so great even today some of the filings remain undecipherable (Wee, pg.1).

Arrogance within the upper ranks of management

According to testimony given from numerous former employees of Enron, belief was widespread within the corporation that Enron was untouchable and beyond any reproach. Throughout its history Enron vehemently refuted numerous charges that its business or records were complicated: when confronted Enron often displayed an attitude of distain for those who didn't understand their matrix-like business model (Pearlstein and Behr, pg. AO1). An overwhelming pride among the execs that they were infallible led executives to believe they could control increasing amounts of risk without danger. Taking on more risk was exactly what they did. An example of this can be found in Enron's relentless pursuit of dominating the energy trading market. At its peak in early 2000, Enron had a 25% market share. Over the internet alone it was trading nearly $3 billion worth of contracts every day via the EnronOnline website. The more trading it did, the more cash it needed to guarantee its obligations in case it was incapable to find enough buyers to match sellers, or vice versa. That is probably why it chose such aggressive, unconventional means to finance its business through off-balance-sheet accounting antics. In the end, Enron did such a great job of duping everybody else that it ended up duping itself.

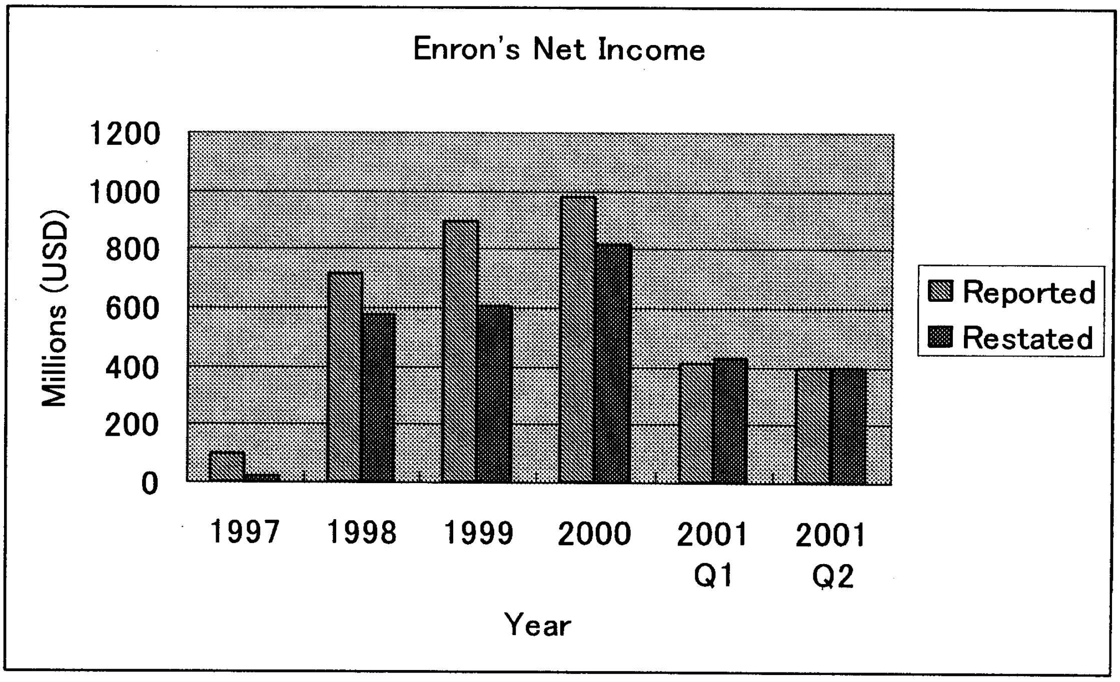
Rampant Greed

It was well known throughout business circles that greed was rampant at Enron. "More than anywhere else, they (Enron's executives) talked about how much money we would make" said an employee who worked under CEO Skilling (McLean, pg.51). Enron structured compensation packages for executives in a way to enrich their own salaries more than generating profits for shareholders. A good example of this could be found in Enron's energy services division that managed the energy requirements of giant companies like Eli Lilly. In this division, executives were compensated based on an abstract market valuation formula that required internal estimates. Therefore pressure was present to inflate the value of the contracts, even though no impact was felt on the bottom line of cash that was generated (France and Zellner, pg.1). Another example can be found in the Enron online division: it made it a practice to borrow revenue from future earnings, figuring that it could easily be replaced before the quarter closed (Schonfeld, pg.2). Top management greed can also be witnessed in the stock plan the company had in place. While most employees were forbidden to sell stock from their retirement plans, executives of the company sold with a furor, netting over a billion dollars in stock sales over the past decade. According to former Enron employees, greed eventually turned into ruthlessness, with backstabbing seen throughout all levels of the company. This also can be evidenced at the top ranks of the company: Enron CEO Skilling is accredited for installing a ranking system for employees that would force out of the company those ranked in the bottom 20%. Therefore, employees were not only encouraged to eliminate outside competitors but each other as well.

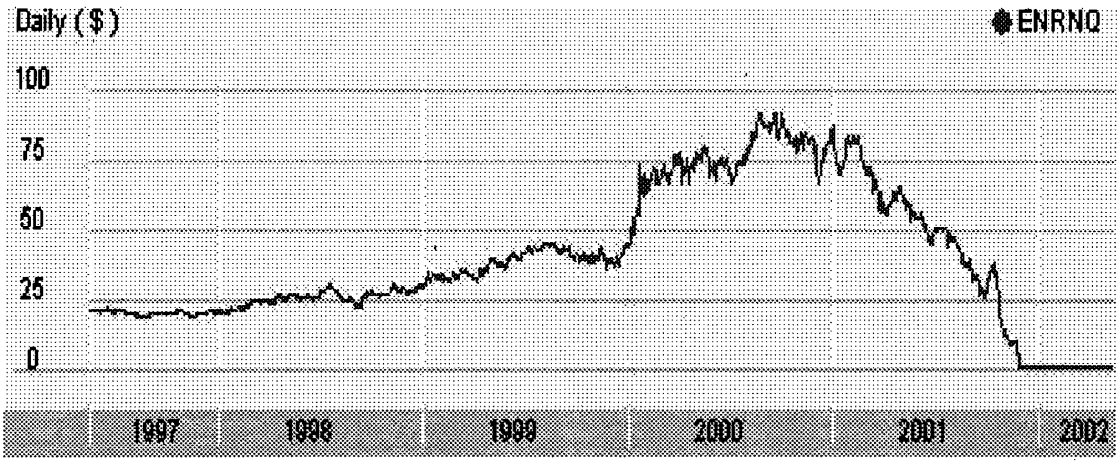
Conclusion

It is highly possible that the U.S. will see several other high-profile corporate bankruptcies over the next few years. Currently, Wall Street appears to be under siege from the public eager to avoid being duped like they were with Enron. Major questions and/ or investigations are currently underway among some major corporations, including Xerox, Global Crossing, Tyco, and WorldCom. Further research into the accounting practices and disclosure practices of all businesses will become a mandatory practice for anyone seeking to invest or have dealings with a company. It is quite possible that many other potential Enrons exist. The bursting of the stock market bubble in 2000 unveiled much excess in corporate America. Enron's rise coincided with the stock market boom. At that time, few questioned a company if it had "new" and "internet" in its business plan. Also, the fact that Enron CEO Lay was a good friend of U.S. president Bush (by his own admission) helped to allay any fears that Enron was

Enron forced to restate earnings since 1997 (Data: Enron Corporation)



The Evaporation of Billions of Shareholder Wealth (Data: Morningstar.com)



anything less than a top-notch company. Ironically, only one thing could have saved the now-defunct corporate cheerleader for deregulation: stricter regulations requiring more financial "transparency". Exactly how much forthrightness needs to be revealed will have to be weighed against a company's right to secrecy. The Securities and Exchange Commission (SEC) is currently conducting additional research to resolve that question.

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